THE DISTRIBUTION OF SURPLUS IN LIFE INSURANCE: A PROBLEM IN SUPERVISION

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The scandals that have been brought to light recently in the insurance field, have drawn especial attention to the question of government supervision. What are the duties of a state in matters of insurance, and how can those duties be most efficiently exercised? How far should the government, state or national, go in the matter of restricting or regulating the right of contract on the part of the public, and how far should the government go in regulating or restricting the operations of the companies? These are questions that both policyholders and those charged with the duties of supervision may well ponder over.

We cannot in a brief paper of this kind, discuss the entire question of supervision in its manifold duties and forms, but will direct our attention to the question of distribution of surplus, and the solution that seems feasible and efficient. In a discussion of this question, we naturally turn to the controversy between Zeno M. Host, the Wisconsin commissioner, and the Equitable Life Assurance Society of New York. The Equitable was organized in 1859 by Mr. Henry B. Hyde, then a young man twenty-five years of age and employed as a clerk in the office of the Mutual Life. He made his plans known to the president of that company and asked for his opinion as to its feasibility. This aroused the ire of the venerable president, for it was rank treason in his mind for a subordinate in that office to even think of starting a competing company. Mr. Hyde was threatened with immediate dismissal if he persisted in his plans. But, without going further into details, the Equitable was organized and located in the same building one story above the office of the Mutual Life. The new company was to be "mutual with capital stock." This is, strictly speaking, a contradiction of

terms, for there can be no stock in a purely mutual company. The plan was to have $100,000 capital stock on which the stockholders were to receive 7 per cent. dividends; the remainder of the earnings was to be divided among the policyholders. This is known as the "mixed" company plan. The stockholders elected the directors and had virtually complete management of the company's affairs. A majority of the stock of the Equitable was until recently held by the Henry B. Hyde estate, which was thus given absolute power to choose the directors of the company and indirectly to manage the investment of the company's funds now exceeding four hundred millions.

The shares owned by Mr. Hyde were left by his will in the hands of trustees until his son, James H. Hyde, should become thirty years of age. The trustees were James W. Alexander, the president of the Equitable; James H. Hyde, first vice-president and heir, and William H. McIntyre, a trusted friend of the elder Hyde. These trustees had the power to vote a majority of the shares in the election of directors, but Mr. Hyde had a veto on the action of the other two, so that, although he could not compel absolutely the election of his choice he could compel the election of directors that were acceptable to him and would do his bidding. This is one of the bones of contention. Many leading authorities hold that the stock should be retired and the management of the company turned over to the policyholders, as has been done in several instances, notably the Phœnix Mutual and the Germania Life. The former retired the stock absolutely, while the latter retained the stock, but gave the policyholders the right to vote at the annual meetings. This is one of the things contended for by Mr. Host, and it is certainly in accord with good business principles. But it concerns only indirectly the question at hand, for deferred dividend policies have been issued by purely mutual companies as well as by stock and mixed companies.

In its competition with other companies for business the Equitable began early to specialize in deferred dividend contracts, about 85 per cent. of its business being of this class, *i. e.*, with distribution periods exceeding five years, most of them being fifteen or twenty years. The legality of this kind of policy was never questioned until Dr. William A. Fricke became insurance commissioner of Wisconsin and he did nothing to test its legality during his term of

office. Not only did he, but every commissioner before him, and Commissioner Giljohann for four years after the expiration of Dr. Fricke's term of office, issued certificates declaring that the Equitable had complied with the Wisconsin law relating to companies operating on the legal reserve plan. In 1902, however, Dr. Fricke issued a book in which he severely attacked the deferred dividend contract and cited the Wisconsin law of 1871 as forbidding the deferring of dividends for more than five years. The law reads as follows:

"Every life insurance corporation doing business in this state, upon the principle of mutual insurance, or the members of which are entitled to a share in the surplus funds thereof, may make distribution of such surplus annually or once in two, three, four or five years, as the directors thereof may determine. In determining the amount of the surplus to be distributed there shall be reserved an amount not less than the aggregate net value of all outstanding policies, said value to be computed by the American experience table of mortality, with interest not exceeding 4½ per cent." (Section 1952, Statutes of 1898.)

Dr. Fricke cited a large number of cases in support of his contention that this law was mandatory, that the word "may" should mean must, etc.

In December, 1902, only a few months after the appearance of Dr. Fricke's book, a policyholder of the Equitable filed a petition in the department of insurance, setting forth that the company had not complied with this law, in that it had not distributed the surplus within five year periods. Mr. Giljohann, who was then commissioner of insurance, declined to take action, on the ground that his term of office had almost expired, and that the matter had better be left entirely to his successor.

When Mr. Host became commissioner, in January, 1903, he granted a hearing to the petitioner, at which both parties were represented by able counsel. On July 31st following, Mr. Host ruled that the company had not complied with the law and gave notice that he would revoke its license unless it filed with him a statement within thirty days declaring that it would comply with his construction of the law. The company did not file such statement, but on the contrary applied to the court for, and obtained, a temporary injunction restraining the commissioner from revoking the license of the company. The case was then heard on its merits

in the Circuit Court for Dane County, and Judge Dunwiddie held that section 1952 was mandatory and that the company *must* distribute the surplus at least once in five years, or in other words, that the deferring of dividends for a longer period than five years was illegal. The company appealed the case to the supreme court, where it was reversed by unanimous decision, directing the lower court to issue a permanent injunction to restrain the commissioner from revoking the license of the company to do business in Wisconsin.

Attempts were made by the attorney-general and the insurance commissioner to get a new trial, but this was denied by the court. A bill was then introduced in the legislature and passed, amending the law, so as to require distribution within five year periods, so that there can now be no dispute as to the meaning of this section.

The query is naturally suggested, what are the arguments for and against the deferred dividend contract? In favor of such contracts, and against short period distribution, it is argued, first, that surplus is necessary as a safeguard for the solvency of the company. The reserve is of course the *standard of solvency,* and in theory the reserve will make good every contract issued, but a working company must also have a surplus, otherwise the reserve would become impaired immediately; hence this resolved itself into a question of *how much surplus* shall be kept on hand to make an adequate safeguard in addition to the reserve. Second, it is argued that deferred policies have been profitable to their holders. The argument that money will double, treble, quadruple, etc., by compound interest has been used with all possible force. In addition to this increase by compound interest, it is argued, that the persistent policyholder will also receive the gain from the forfeitures of lapsed policies. Third, it is argued, that the deferring of dividends will in a large measure prevent lapses, by making the policyholder feel that if he stays to the end of the period he gains, but if he drops out before maturity he loses. Fourth, it is argued that it is a matter of right of contract, that any one has a right to take such a contract if he chooses. This argument is advanced by many of the best authorities on insurance in the United States. In this connection the opinions of the insurance commissioners of the various states are of especial interest.

Mr. Hadley, the deputy commissioner of Michigan, writes: "I do not believe in a law compelling companies to distribute their

surplus at least once in five years. I think that that is a matter to be regulated by the terms of the contract."

Mr. Cole, of Mississippi, writes: "The only thing that the law should undertake to do, in my opinion, is to see that the companies fulfill their contracts rather than undertake to prescribe contracts for the companies."

Commissioner Drake, of the District of Columbia, who was for two years deputy superintendent of insurance of Ohio, and the technical official of that department, writes: "While I have favored and radically advocated for the past thirty-five years—after policies become non-forfeitable—the annual distribution only of surplus, yet I do not approve of Commissioner Host's course toward the Equitable, . . . for the reason that it seems to me that inaction along that line for so many years by his predecessors had established a precedent that time and usage had caused to become law within itself."

Says Mr. Monroe, of Arkansas: "I think people taking insurance should be allowed by law to make contracts to suit them. A state makes a mistake when it undertakes to say to her citizens that they must not make any kind of a contract unless the making of such contract injures some other citizen."

Says Commissioner Young, of North Carolina: "It occurs to me that where a proper and reasonable contract is made between an insurance company and its patrons that the law should allow the complete carrying out of the contract, and should not, in my opinion, unnecessarily interfere with or 'cramp' them in their dealings."

Commissioner Upson, of Connecticut, writes: "In this state the law does not require such a distribution, and I do not believe that such a law should be enacted."

From the Illinois department we have this reply: "The law of this state provides that a life insurance company may make distribution of such surplus once in two, three, four or five years, as the directors may from time to time determine. The appellate court of this state has held, 97 App. Rep. 555, that this provision is not mandatory, but permissive."

Commissioner Durham, of Pennsylvania, says: "I do not believe that the matter needs any legal regulation, but should be left to be regulated by the terms of the contract between the company and its members."

Commissioner Gray, of Rhode Island, says: "I am inclined to

the belief that such a law, if it should impair the obligation of their contracts to the extent of requiring them to change any of the terms of that contract would be unconstitutional."

Commissioner Dearth, of Minnesota, writes: "I can see no good reason why an applicant for a policy of insurance in any company should not have the legal right at least to accept any form of contract from the company as might be deemed desirable, or to his mutual interest, so long as such contract is not against good public policy or does not interfere with the rights or interests of any other party."

In Oregon, Tennessee, Iowa, Vermont, New Hampshire, Virginia, Colorado, Ohio, Arizona and Canada: "There is no such law." "The question has never been raised;" and the commissioners decline to venture an opinion.

Since the above replies were received, however, Commissioners Folk, of Tennessee, and Cutting, of Massachusetts, have expressed themselves in favor of short term distribution in their reports.

From Nevada alone comes an answer in favor of Commissioner Host's contention for short period distribution of surplus, and the only reason given for the answer by the commissioner of that state is that he has read Mr. Host's brief on that subject.

Thus it appears that nearly all the commissioners of insurance in the United States are opposed to the stand taken by Dr. Fricke and Mr. Host. Even those who have declined to venture an opinion on the subject say this much, that there is no such law in their states, and that the question has never been raised. Some of the commissioners have expressed themselves as being in favor of compelling the companies to "render an account of their business" at short intervals, but there is a vast difference between such accounting and mere distribution of surplus at short intervals, for, while the law prescribes a minimum amount to be kept as reserve, it does not prescribe a maximum, nor does it forbid the setting aside of a part of the surplus as a so-called "special reserve" which is merely a subterfuge to evade the law. It should also be remembered that an account is rendered every year in the annual statements required to be filed with the commissioner of insurance, and if the data contained in such statements are insufficient to show the results to policyholders, then the commissioners should call for and publish such additional information as is necessary to show the financial

strength of the companies, their methods of conducting the business, and the actual results to policyholders, for the surplus is a part of the savings bank feature of life insurance, and if it is carefully invested and handled by honest and efficient financiers at an expense commensurate with the service rendered, then it matters not whether it is distributed once in five years, once in ten years, or once in twenty years.

The arguments against deferred dividend contracts and for distribution at short intervals are as follows: first, if a person dies or lapses his policy before the end of the period, he loses the surplus accumulated up to the time of death or lapse. That is, if the policyholder had taken an annual dividend policy he would not forfeit so much as on the deferred dividend policy. This argument is perfectly good as far as it goes, but carried to its logical conclusion, it would forbid the issuance of all limited payment life policies and all kinds of endowment policies, for in the event of death the pure term policies would be the best, because the policyholder would have paid in less money on that plan than on any other, and the amount of indemnity would be the same. In case of death the policyholder loses the reserve on limited payment life and endowment policies, and this amounts in most cases, to much more than the surplus on any kind of policy.

Second, it is argued that the accumulation of a large surplus leads to extravagance in expenses. In this connection we need only mention the high salaries, the ornamentation of buildings, the prizes, bonuses and extra commissions given to increase the volume of new business. But, to ascribe all this to the accumulation of surplus is not warranted by the facts. It is perhaps true in part that a large surplus serves as an inducement to extravagant expenditures, but the same extravagance is found in companies that do not accumulate a large surplus. This was clearly shown by the investigation of the Washington Life. In that company, the surplus had been very low for many years, ranging from 3 to 5 per cent. of the assets, while the surplus in other companies ran from 10 to 25 or 30 per cent. The extravagance revealed by the investigation of the Washington Life was a surprise even to those who were well informed. It has been stated, somewhat humorously, that under the old management the surplus was squandered so fast that it did not have time to accumulate. If the statement is true that "the deferred

dividend contract is the root of all the evils in life insurance," then a company which distributes its surplus annually should be free from those evils. What are the facts? One company which claims to be a purely annual dividend company, shows an increase in salaries far greater than that of the business of the company. The per cent. increase in the various items from 1893 to 1904 was as follows:

1. Insurance in force	59.35 per cent.
2. Gross income	59.75 per cent.
3. Surplus	18.21 per cent.
4. Assets	63.63 per cent.
5. Commissions to agents	60.37 per cent.
6. Salaries	74.23 per cent.

The increase in salaries in this case is entirely out of proportion to the other items, and yet it is claimed to be a purely annual dividend company. The same extravagance is also found in some of the assessment companies that have neither reserve nor surplus accumulated. The expenditures of some assessment companies has risen to such an extent that the legislature of the State of New York, in 1905, found it necessary to pass a law limiting their expenses. How the accumulation of surplus can be responsible for the lavish expenditures of such associations has not been explained.

Third, it is argued that the accumulation of surplus leads to the misuse of trust funds in speculation and investment for the personal profit of the officers. This is also true in part, but in part only, for the entire reserve may be thus misused, provided it is made to earn sufficient interest to comply with the law. For example, if money will earn in the market, say 5½ per cent., and only 4 per cent. is required by law to maintain the reserve, there is a margin of 1½ per cent. Thus, the financiers may, if they desire, so use the money as to earn 4 per cent. or 4½ per cent. for the company while they pocket the balance. This may be done by direct personal loans, by deposits in banks and trust companies, and borrowing from them, or by the renting of buildings to favored tenants, or in a variety of ways that we need not dwell on here.

Fourth, it is argued that the charters of the companies and the laws of some states forbid the deferring of dividends for more than five years. It will be observed that the language of the Wisconsin law, before the recent amendment, was permissive only, unless it

could be clearly shown that the word "may" would have to be construed to be mandatory in order to give effect to the law. The supreme court held that it was permissive only and the same construction was put upon a similar law in the State of Illinois. But in the Wisconsin case it was argued that the context of the law made it mandatory on the theory that a corporation can do only that which is specified. The law specified that distribution might be made within five years, but said nothing about longer periods, hence it is claimed that the word "may" applied only within the five-year period. The court, however, did not admit the force of that argument.

The company also relied on a section (87) of the laws of New York passed in 1868, which reads as follows:

> "Any domestic life insurance corporation which by its charter or articles of association, is restricted to making a dividend once in two or more years may hereafter, notwithstanding anything to the contrary in such charter or articles, make and pay over dividends annually, or at longer intervals, in the manner and proportions and among the parties provided for in such charter or articles."

The commissioner denied that this law had any effect in Wisconsin, but if it modifies or alters the charter or articles of association in any way, and the Wisconsin law provides that the companies shall conduct their business according to their charters, then it must have some force even in Wisconsin, and it is difficult to see how the supreme court could hold otherwise than it did.

Another case which is of special interest at this time, is one brought against The Independent Order of Foresters, decided recently by the supreme court of Missouri. In that case it was held that the policy, after three payments had been made, had an equity in the surplus of the association that gave it a surrender value, which carried the policy beyond the date of lapse. In this case, it may be said, the court decided according to what *ought* to be the rule. In the Wisconsin case, the court decided according to what *is* the rule in law and practice, but did not necessarily aim to set up an ideal.

But the controversy is by no means limited to Wisconsin. It is of national and international importance, for the three largest companies are doing business in all parts of the world. The con-

troversy now going on in New York offers a great deal of food for reflection. But that has been sufficiently aired in the press to make a review of it in this connection unnecessary. Suffice it to say that the exposures that have been made show clearly that there are numerous defects in the state laws and that there has been a great deal of the sin of omission on the part of state officials, but it also shows with equal clearness that the policyholder has been grossly negligent with respect to his own interests. Seldom if ever does he read his own policy, or scan the annual statements of his company, but what is worse he never attends the annual meeting, even if he has an opportunity to do so. At the annual meeting of one of the large companies, only eleven members were present, though about eight hundred thousand had the right to vote. The great distance between the policyholder's residence and the company's home office makes attendance at the annual meetings impracticable, besides it would be impracticable to conduct business if such large numbers could be present: The result of this condition of things is that a few men have gained control, and the policyholder, the one who above all others has an interest in the company, has lost hold of the purse strings.

From these facts, and from statistics that are easily obtainable, to show the trend of dividends, expenses, earnings, etc., it appears that the deferred dividend policy is not the source of all evils in life insurance, although that assertion has been made repeatedly by men who ought to be well informed. Nor is the deferred dividend policy an unmixed evil in itself, for, in well managed companies, such policies have been even more profitable than annual dividend policies, and as far as the gambling element is concerned it is not even as bad as the forfeiture of the reserve in high priced endowment policies in case of death.

The root of the evil lies much deeper than the mere question of distribution of surplus. Comparing expenses of companies issuing nothing but annual dividend policies, with the expenses of deferred dividend companies, we find no material difference. It is argued with a great deal of force that deferred dividend policies have been disappointing to their holders, but the same is true of annual dividend policies. The dividends on an annual dividend policy should increase from year to year, with the increase in the amount invested, as they do in conservative and well managed com-

panies. But numerous cases can be cited where the dividends on such policies have been stationary or even decreasing from year to year. What, then, is the remedy? First of all, there must be publicity. Publicity has indeed been coming during the last few months. The trouble is that it smacks so much of yellow journalism and that the statistics published have been so poorly digested. Rumors have been stated as facts, and figures have been cast together to make a showing—anything to make an article under a "scare head" to sell the paper.

Comparisons have been made almost entirely on the basis of premium receipts and growth of business. This is both illogical and unfair. In one of the magazines, which is publishing a series of articles on insurance, there appears a table showing the percentage of dividends to premium receipts in the three large New York companies and the percentage on the same basis of the Phœnix Mutual of Connecticut. The percentages are as follows:

Equitable	9.39 per cent.
Mutual Life	11.60 per cent.
New York Life	9.54 per cent.
Phœnix Mutual	19.04 per cent.

The difference between the Phœnix Mutual and the New York companies is indeed striking. But does it mean anything? Percentages corresponding with those given above for the Connecticut Mutual and the Michigan Mutual are 25.50 per cent. and 20.90 per cent. respectively, while in another company, which is in good standing, the percentage on the same basis was about one-third of 1 per cent. But such comparisons are not worth the making except for the express purpose of misleading. They are dishonest and should be suppressed. They are not a true index of a company's efficiency, because one company may be rapidly expanding, while another company has a large amount of paid up policies on its books that call for large dividends, while the premiums are low, and *vice versa*. There is no single basis on which comparisons may be made with justice to all companies. The items must be separated, so as to show the investment expense per unit invested, and the insurance expense per unit, say $1,000, of insurance written or in force; the high priced endowment business and the single premium life business must be separated from the low priced life and term

business, because each class of business has expense items and ratios peculiar to itself. Among these may be mentioned the relatively high commission paid on life policies compared with the commissions on endowment policies; the high commissions on new business as compared with renewals, and the high investment expenses connected with endowment insurance as compared with ordinary life and term insurance. The importance of these points will be seen when it is considered that in one company the percentage of endowment insurance to the total in force is several times as high as in other companies; that in one company the new premiums exceed the renewals, while in another company the new premiums are only about one-tenth as large as the renewals, and so on. These are distinctions of vital importance to an intelligent understanding of the insurance business as it exists to-day, and it is high time that the correspondents of the daily press take pains to analyze their statistics, if they desire to be of real service to the public. If the statistics published were cast into intelligible form, and presented so as to show the true and final results to policyholders, much of the present abuse in life insurance management would disappear.

But publicity alone is not sufficient. There must also be effective control by the policyholders, and this can be brought about in either of two ways, viz., by a representative system of government similar to that now in vogue in most of the fraternal associations, or by the Australian system of voting through the mails. It is not intended here to uphold fraternal insurance as it exists in the United States, for the system of raising funds by post mortem assessments has proven a failure. But the representative system has much to commend it. It is at the very foundation of the American governmental system, and has worked well in thousands of associations of various kinds. The only drawbacks are the expense of attending meetings, and the danger of representation being lost on the way, as has been the case, only too often, in political conventions.

The Australian system of voting is as follows: Every candidate for an office in the company must announce his candidacy before a specified date. A list of such candidates is then sent to each member qualified to vote; he marks the names he desires to vote for, and returns the list in a sealed envelope to the home office, where they are all opened and counted on a certain day fixed for election.

This method is economical and gives all members a voice in

the election, but it does not afford opportunities for discussion, and this is no small advantage in the representative system. The Australian system may still offer opportunity for corruption in elections, but the counting of the votes could undoubtedly be so safeguarded as to reduce this danger to a minimum.

With a system of company management that would make the officers directly responsible to the policyholders, much of the abuse in insurance management would disappear and the necessity for government supervision of any kind would be greatly lessened. But government supervision has come to stay, and there is need for its strengthening and expanding. The great lack of uniformity in the state laws, the duplication of work by many departments where one is sufficient, as well as the laxity and incompetency on the part of some state officials, point more strongly than ever to the necessity for national supervision of all companies doing an interstate business.